

***United States Court of Appeals
for the Second Circuit***



**BRIEF FOR
APPELLEE**

77-4047

Signed

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

NICHOLAS VICTOR FINDLER and
CATHERINE FINDLER,

Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

ON APPEAL FROM THE DECISION OF THE
UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

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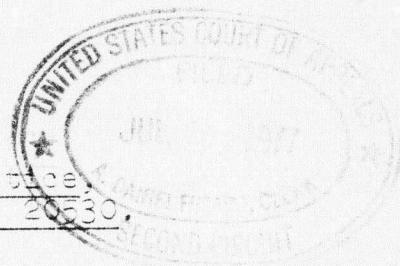


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ON APPEAL FROM THE DECISION OF THE
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⁶⁶
BRIEF FOR THE APPELLEE

STATEMENT OF THE ISSUE PRESENTED

Whether the Tax Court was correct in determining that amounts received by taxpayer from a National Science Foundation research grant were not excludable from gross income as amounts received as a fellowship grant within the meaning of Section 117 of the Internal Revenue Code of 1954, because they were paid as compensation for services.

STATEMENT OF THE CASE

This case involves a deficiency in taxpayers' 1972 federal income tax determined by the United States Tax Court in the amount of \$378.88. (R. 1.)^{1/} The Tax Court's memorandum findings of fact and opinion (Op. 1-21, Appendix B, infra, pp. 40-60), which are reported at 35 T.C.M. 1602 (1976), were filed on November 22, 1976. (R. 5.) The court's order and decision was entered on November 29, 1976. (R. 5.)^{2/} Taxpayers subsequently filed separate motions to vacate the court's decision and for review by the full court on December 30, 1976, and on January 3, 1977, they filed a motion for reconsideration of the opinion of November 22, 1976. (R. 5.) By an order entered on January 3, 1977, the court denied taxpayers' motion for review of the opinion by the full court. (R. 5.) Taxpayers' notice of appeal to this Court was filed on February 14, 1977. (R. 2, 5.) Jurisdiction is conferred on this court by Section 7482(a) of the Internal Revenue Code of 1954 (26 U.S.C.).

The facts, as found by the Tax Court and as otherwise disclosed in the record, may be summarized as follows:

Taxpayers, husband and wife,^{3/} who were residents of Snyder, New York, at the time of the filing of their petition

^{1/} Taxpayers, who are appearing pro se, filed with their brief an appendix containing copies of some of the documents in the record pertinent to this appeal. They are the order and decision of the Tax Court (R. 1), the notice of appeal (R. 2-3), and the docket entries (R. 4-6). For the court's convenience we have included a copy of the Tax Court's memorandum findings of fact and opinion in Appendix B to this brief.

^{2/} The Tax Court on November 29, 1976, vacated the decision in favor of the Commissioner it previously entered on November 23, 1976, and entered an order and decision in favor of the Commissioner on November 29, 1976. (R. 1.)

^{3/} Catherine Findler is a party to the action solely by virtue of having filed for 1972 a joint return with her husband Nicholas

in this case filed a joint Federal income tax return for the calendar year 1972 with the Internal Revenue Service Center at Andover, Massachusetts. (Op. 2, Appendix B, infra, p. 41).

During the year 1972 and for some years prior thereto Nicholas Victor Findler (taxpayer) was a professor in the Department of Computer Science at the State University of New York at Buffalo (the University) and was also the Director of Graduate Studies at that institution. He was not a candidate for any scholastic degree during the year 1972. (Op. 2-3, Appendix B, infra, pp. 41-42.)

On April 5, 1969, the Research Foundation of the State University of New York, Albany, New York (the grantee institution), submitted to the National Science Foundation (hereinafter "NSF" or "the Foundation")^{4/} a proposal for a research project to be conducted under the auspices of taxpayer as principal investigator, requesting a grant to fund the project. (Ex. 2-B.) The research proposal submitted by the grantee institution stated that it was submitted on behalf of the University, that the principal investigator was taxpayer, and that the title of the proposed research was "Extensions to and Applications of an Associative Memory, Parallel Processing Language, AMPPL." The proposed starting date was stated to be July 1, 1969, the proposed

^{3/} (continued)

Findler, the recipient of the National Science Foundation grant. For convenience all references to the taxpayers will be in the singular.

^{4/} The National Science Foundation was created by the National Science Foundation Act of 1950, c. 171, 64 Stat. 149, Sections 2-16, as amended (42 U.S.C. §§ 1861-1875). It is an agency of the United States authorized and directed to initiate and support scientific research programs, among others. See, Carroll v. Commissioner, 60 T.C. 96, 98 (1973); Ex. 7-G, Foreword.

duration two years, and the amount requested \$67,404. The proposal stated that the research would be conducted at the University and contained an outline of the proposed project. It described the facilities available at the University for use in the project and a detailed resume with respect to taxpayer. The resume showed that taxpayer had both a B.E. and a Ph.D. degree, that he had held a number of positions as professor at various universities (as well as research positions), that he had won a number of prizes and fellowships, had published a number of articles (many of them dealing with computer studies), and had published two books. The budget contained in the research proposal indicated that of the \$67,404 requested the University's contribution would be \$6,740, part of which was a percentage of the salary of the principal investigator, taxpayer. (Op. 3-4, Appendix B, infra, pp. 42-43.)

The staff summary contained in the "Proposal Review Summary and Program Recommendations" (Ex. 3-C) prepared by a program director of NSF with respect to the research proposal submitted by the grantee institution stated as follows (Op. 4, Appendix B, infra, p. 43):

This is good work in an important area. Several proposals for construction of associative memory and parallel processing machines have been made and one or two are being constructed but a major barrier has been the design of appropriate programming languages. This constitutes a conceptual as well as practical barrier since it is difficult for people to visualize the application of parallel processing and associative memory to a wide range of problems. Prof. Findler is attacking precisely this problem and should be supported.

Under date of August 14, 1969, the grantee institution received a letter (Ex. 4-D) from NSF stating that a grant of \$54,200 was made with respect to the proposal and that the Foundation required that the grant be administered in accordance with "Grants for Scientific Research," June 1963 (as amended December 1963 and supplemented by Important Notice of January 24, 1966), and the approved budget summary. (Op. 5, Appendix B, infra, p. 44.)

On December 15, 1970, the grantee institution submitted to NSF a supplementary research proposal requesting an extension of the original research grant. (Ex. 8-H.) This supplemental proposal was likewise submitted on behalf of the University with taxpayer as principal investigator. The title of the proposed research was stated to be, "Further Studies Using the Associative Memory, Parallel Processing Language, AMPPL-II." The starting date proposed was September 1, 1971, the proposed duration three years, and the amount requested \$357,713. This supplemental research proposal set forth a summary of the work which had been done over the last 18 months using the support of NSF and activities which were currently being undertaken. This supplemental proposal also contained a resume of taxpayer, the principal investigator, and a proposed budget. The proposed budget showed that the University contribution in connection with the projects described would be made in accordance with NSF Notice No. 31, "Cost Sharing on Research Projects," and that the University contribution included a portion of the salary of the principal investigator. (Op. 5-6, Appendix B, infra, pp. 44-45.)

Under date of January 19, 1972, the grantee institution received a letter from NSF stating that an additional \$150,500 was granted for renewed support of the project entitled "Associative Memory, Parallel Processing Language, AMPPL-II" as outlined in the supplemental proposal. (Ex. 9-I.) The letter stated that the funds were intended to support the project for an additional 24 months. This letter further stated (Op. 6-7, Appendix B, infra, pp.45-46):

The Foundation shall have the right to require the grantee, at no cost to the grantee, to duplicate, or permit others to duplicate, and deliver to the Foundation or to any person designated by the Foundation, any computer programs, instructions or other software produced under this grant, which may, in the opinion of an authorized Foundation official, be useful for research, education or other legitimate purposes by others; provided that no such requirement shall be imposed without affording the grantee a reasonable opportunity to correct errors or to document errors and ambiguities therein.

Except as modified by this amendment, including Enclosure R-12, the grant conditions remain unchanged.

Enclosure R-12 (Ex. 5-E) which governed some aspects of the administration of the grant, provided, with respect to patents and inventions, that whenever any invention which is or may be patentable is conceived or first actually reduced to practice in the course of the grant, the grantee shall furnish the Foundation with complete information thereon and the Foundation shall have the right to determine whether or not and where a patent application shall be filed and to determine the disposition of the invention and title to and rights under any application or patent that may result. (Op. 7, Appendix B, infra, p. 46.)

Enclosure R-12 stated further that the grant should be administered in accordance with Part II of NSF 69-23, "Grants for Scientific Research," (Ex. 7-G) as modified by NSF Important Notice No. 40. (Ex. 6-F) (Op. 7, Appendix B, infra, p. 46).^{5/}

NSF 69-23, a guide containing instructions for the submission of research proposals and rules for grant administration (Ex. 7-G, Foreword),^{6/} states that NSF is authorized to initiate and support both scientific research and programs to strengthen scientific research potential (Op. 8, Appendix B, infra, p. 47). Part I of the guide regarding the submission of proposals states that proposals normally are initiated by the scientist interested in doing the work and submitted on his behalf by his organization; and that most proposals received by NSF are submitted by universities and colleges on behalf of their staff. (Op. 8, Appendix B, infra, p. 47 ; Ex. 7-G, p. 3.) An application must contain a description of the proposed research including its objectives, and its expected significance in relation to the current state of knowledge in the field. (Ex. 7-G, pp. 6-7.) The guide states that appraisal of the scientific merit of the proposed research depends to large degree on this information. (Ex. 7-G, p. 7.) Proposals are evaluated by scientists serving as members of the NSF staff and, in general, proposals are supported in the order of their merit to the extent permitted by available funds. (Op. 9, Appendix B, infra, p. 48 ; Ex. 7-G, p. 13.)

^{5/} Important Notice No. 40, dated July 6, 1971, stated that it supplemented and in some instances superseded certain provisions of Part II of NSF 69-23 which concerned the administration of grants. (Ex. 6-F, p. 1.)

^{6/} NSF 69-23 outlined basic grant procedures in existence at the time of the grant involved in this case, although since that time they apparently have not been altered substantially. See Ex. N, p. 1.

An application must identify a "principal investigator" (Ex. 7-G, p.5) to be responsible for direct supervision of the project and to participate in the research whether or not his institution is to receive any reimbursement of his salary from grant funds (Op. 8, Appendix B, infra, p.47; Ex. 7-G, p. 7). The qualifications of the principal investigator, which must be listed in the application, are very important to NSF in evaluating a proposal. (Ex. N, p. 2; Tr. 21-22.)

Regarding salaries and wages, the guide provides that as a general policy the Foundation recognizes that salaries of tenured and non-tenured faculty members associated with the research constitute appropriate direct costs in proportion to the time devoted to the research. However, the summer salary for a faculty member generally will not be reimbursed for more than two-ninths of his academic salary. (Op. 8, Appendix B, infra, p.47; Ex. 7-G, p. 9.) And the guide further provides (Op. 8-9, Appendix B, infra, pp. 47-48; Ex. 7-G, p. 10):

The Foundation regards research as one of the normal functions of faculty members at institutions of higher education. Compensation for time spent on research within the term of appointment is deemed to be included within the regular institutional salary of the faculty member. Therefore, grant funds may not be used to augment the total salary or rate of salary of faculty members during the period of time covered by the term of faculty appointment or to reimburse faculty members for consulting or other time in addition to a regular full-time institutional salary covering the same general period of employment. In any Foundation supported scientific research grant, the institution is deemed to be the grantee and responsibility for work performed by a faculty member under such a grant rests with the institution.
(Emphasis added.)

Part II of NSF 69-23 concerns the administration of research grants. It provides that (Op. 9, Appendix B, infra, p. 48 ; Ex. 7-G, p. 19):

Primary responsibility for general supervision of all grant activities rests with the grantee institution; the principal investigator is responsible for the scientific work. Grantees and principal investigators are encouraged to seek advice and opinion from the Foundation on problems that may arise. * * *

Important Notice No. 40 which supplements Part II of NSF 69-23, states in addition (Ex. 6-F, p. 1):

The Foundation looks to and expects grantee institutions to adopt and follow sound, consistent, business-like policies and practices in the management and administration of NSF supported projects. Considered judgment must be exercised in attaining the research objectives within the limits of resources provided. (Emphasis added.)

Concerning adherence to the grant budget, NSF 69-23 provides (Op. 9, Appendix B, infra, p. 48 ; Ex. 7-G, p. 20):

The grant letter includes a budget summary which lists the items for which funds are provided. The grant is made to the investigator's institution and it is the institution which bears the primary responsibility for fiscal accountability. * * *

The Important Notice which superseded NSF 69-23 in this regard, states that the grantee must obtain specific written approval from NSF for the purchase of different types equipment costing more than certain amounts. (Op. 10, Appendix B, infra, p. 49 ; Ex. 6-F, p. 3.) A Research Grant Budget & Fiscal Report, NSF Form 98 (Ex. 12-L) makes specific reference to "salaries and wages" in its breakdown of the total budget.

Regarding adherence to the original research objectives, NSF 69-23 provides (Op. 9, Appendix B, infra, p. 48; Ex. 7-G, p. 21-22):

The Foundation believes that the principal investigator, operating within the established policies of the grantee institution, should feel free to pursue interesting and important leads which may arise during the conduct of the research. * * * However, on occasions when new and promising leads or fruitless lines of inquiry do arise, leading to possible major deviations from original research objectives, the Foundation must be informed. (Emphasis added.)

The important notice supplements this provision as follows
(Ex. 6-F, p. 3):

4. Adherence to Original Research Objectives

* * *

Neither the phenomenon or phenomena under study, i.e., the broad category of research, nor the stated objectives of the research effort, shall be changed except with the written approval of the Foundation.
(Emphasis added.)

The Important Notice provides that written NSF approval is required either to change the principal investigator or to continue research work for more than three months without the participation of the principal investigator (Ex. 6-F, pp. 3-4). And in this regard, NSF 69-23 provides (Ex. 7-G, p. 26):

As a general rule, the availability of the services of the principal investigator named in the grant instrument is one of the conditions of the grant. Consequently, the Foundation should be informed immediately when it appears to be impossible for the principal investigator to continue to direct the research. Under these conditions, Foundation policy is that research under the grant shall be discontinued unless a substitute principal investigator is available who is acceptable to the Foundation.

However, NSF will not automatically transfer the grant from one institution to another if, for example, the principal investigator transfers. Rather, a new proposal must be submitted by the new institution. (Op. 10, Appendix B, infra, p. 49; Ex. 7-G, p. 26).

NSF 69-23 requires the grantee to file an annual technical report on the progress of the grant, and for grants covering a period in excess of a year, a more comprehensive^{7/} final report. (Ex. 7-G, p. 22.) In addition, Important Notice No. 40 requires, unless otherwise specified in the grant letter, a fiscal report after the termination of the grant or the exhaustion of funds (Ex. 6-F, p. 4).

The right to use published material resulting from the performance of the research was reserved to the United States Government. (Op. 10, Appendix B, infra, p. 49.)

Concerning the general relationship between the Foundation and the grantee, "NSF Grant Administration Manual," October, 1973 (NSF 73-26) (Ex. 10-J)^{8/} provides that a grant establishes a "cooperative relationship" between NSF and the grantee in which the Foundation agrees to provide "financial support to help defray the costs of the project" and in addition that the official named in the grant letter agrees on behalf of the grantee institution "to the performance of the project, to the prudent management of the funds provided by the grant, and to the provisions of the grant instrument." (Ex. 10-J, p. 1.)

^{7/} When the grant is for a period of one year or less, only a final letter report is required. (Ex. 7-G, p. 22.)

^{8/} NSF 73-26 still in effect as of January 24, 1976, while not in effect during the existence of the grant in this case, is relevant to the general framework and purpose of the grant. In his letter to the Internal Revenue Service dated January 24, 1976, Charles F. Brown, NSF General Counsel, states that procedures contained in NSF 73-26 have not substantially altered NSF 69-23. (Ex. N, p. 1.)

During the first half of 1972 taxpayer performed his normal teaching and administrative duties at the University while working on the project for which the grant was received from NSF. During this period none of taxpayer's salary was reimbursed to the University through the NSF grant. From June 27, 1972, throughout the end of that year taxpayer was on sabbatical leave from the University. He spent this entire period in various European cities where he was engaged in work on the research project approved by NSF, for which he was principal investigator. (Op. 10-11, Appendix B, infra, p. 49.)

For the period June 27, 1972, to December 31, 1972, taxpayer received \$11,268.98 of which \$5,628.98 was paid to him by the University and \$5,640 was paid to him by the grantee institution with funds provided by NSF under the research grant. The \$11,268.98 represented taxpayer's then current salary from the University for a six-month period, with one half being paid by the University and the other half under the research grant. Taxpayer continued to participate in the retirement program of the University during the last six months of 1972 and also in the University sponsored hospitalization and group health program. Federal and state income taxes and Social Security taxes were withheld from all payments which taxpayer received during the last six months of 1972, including those received from the grantee institution from funds provided under the NSF grant. Taxpayer received both his salary payments from the University and his payments from the grantee institution every two weeks during the period June 27, 1972, through December 31, 1972. (Op. 11, Appendix B, infra, p. 50.)

During 1972 taxpayer was assisted in the research he performed in accordance with the grant proposal by four graduate students. Provision for participation by these graduate students had been made in the NSF budget awarding the grant. During the period June 27, 1972, through the end of that year taxpayer performed none of his regular services for the University. (Op. 12, Appendix B, infra, p. 51 .)

Taxpayers on their federal income tax return for the year 1972 deducted \$1,800 from their total reported income with the explanation that one half of the amount received by petitioner during the last six months of 1972 had been a "post-doctoral fellowship." (Op. 12, Appendix B, infra, p. 51.)

Respondent in his notice of deficiency increased taxpayers' income by \$1,800 with the explanation that the amount of \$1,800 excluded by taxpayers from income as a fellowship grant "is not allowable since the stipends received with respect to the National Science Foundation Grant represent compensation for services rendered and do not qualify under Section 117 of the Internal Revenue Code of 1954." (Op. 12, Appendix B, infra, p. 51.)

Taxpayers petitioned the Tax Court contending that the NSF grant constituted a fellowship grant within the meaning of Section 117(a) of the Internal Revenue Code of 1954, and was therefore excludable from income to the extent provided in Code Section 117(b). The Tax Court held for the

Commissioner, finding that the grant involved represented compensation for services. (Op. 17, Appendix B, infra, p. 56.)

Taxpayers appeal.

SUMMARY OF ARGUMENT

Section 117 of the Internal Revenue Code of 1954 provides generally that any amount received by a taxpayer as a scholarship or fellowship grant is excludable from gross income, but if the taxpayer is not a candidate for a degree at an educational institution, the exclusion generally is limited to a rate of \$300 per month. Taxpayer attempted to exclude from his gross income, at the rate of \$300 per month, amounts he received from the University during the second half of 1972 which were attributable to a National Science Foundation research grant.

The Commissioner in the Treasury Regulations has defined the term fellowship as an amount paid to an individual to aid him in the pursuit of research. The applicable Regulations specifically except from the category of excludable grants payments which essentially represent compensation for services or research primarily for the benefit of the grantor. The Supreme Court in upholding the validity of these Regulations stated that this definition of a fellowship comported with the ordinary understanding of the terms as relatively disinterested "no-strings" grants not made in exchange for any substantial quid pro quo. Bingler v. Johnson, 394 U.S. 741, 751 (1969). The NSF payments taxpayer attempted to exclude in no way resembled excludable grants as defined by the Regulations.

In the first place, it is clear that NSF made the grant because it was convinced that the specific research project merited support, and that the taxpayer was capable of success. The NSF pamphlet outlining proposal application procedures make several references to the research "objective". For example, taxpayer could not substantially modify his effort to achieve his objective without NSF approval. Additionally, this and several other grant conditions demonstrate that NSF kept several "strings" of control over the direction of the work and consequently the use of its money. These factors are indicative of the quid pro quo expected by NSF in return for the money granted.

The procedures dictated by NSF and followed by the University for payment of NSF monies are additional indications that the funds were paid for services rendered. For example, NSF provided that the grant funds together with University contributions could not exceed the recipient's normal salary amount. Additionally, during the period in question, taxpayer received his regular salary amount, at regular intervals; he continued to benefit from University health plans and enjoyed full faculty privileges.

The Tax Court in Carroll v. Commissioner, 60 T.C. 96 (1973) considered the excludability of an NSF research grant in very similar circumstances, and after analyzing the above-noted factors concerning procedures for control and the treatment of the funds, properly found, as it did below, that monies paid for work on such a project were not excludable pursuant to Code Section 117 because they represented compensation for services.

Furthermore, on the facts present here, the amounts received as a grant are not excludable under another provision of the Regulations which provides for the exclusion of non-compensatory grants made for the primary purpose of furthering the education and training of the recipient. Cases which have found amounts excludable under this provision involved grants which were given without concern for the attainment of a specific objective, with virtually no conditions for control over their actual use, and with none of the earmarks of salary payments. Rather, they were grants the express purpose of which was to improve the overall quality of specialists in a particular area. Accordingly, all such authorities are distinguishable.

Because the Tax Court's finding of ultimate fact that the payments here involved were compensation is amply supported by evidence in the record, and is not clearly erroneous, the decision in favor of the Commissioner should be affirmed.

ARGUMENT

THE TAX COURT WAS CORRECT IN DETERMINING THAT THE AMOUNTS RECEIVED BY TAXPAYER BY VIRTUE OF THE NATIONAL SCIENCE FOUNDATION RESEARCH GRANT WERE NOT EXCLUDABLE FROM HIS 1972 INCOME PURSUANT TO CODE SECTION 117

A. Introduction

Section 117(a) of the Internal Revenue Code of 1954, Appendix, infra, provides for an exclusion from gross income of any amount received as a "scholarship" or "fellowship grant."^{9/} Although the statute does not define these terms, they have been the subject of administrative and judicial interpretation. The Commissioner, has provided in Section 1.117-3(c) of the Treasury Regulations (26 C.F.R.) that:

§ 1.117-3 Definitions.

* * *

(c) Fellowship grant. A fellowship grant generally means an amount paid or allowed to, or for the benefit of, an individual to aid him in the pursuit of study or research. * * *

In addition, Section 1.117-4 of the Regulations provides^{10/} in part:

Items not considered as scholarships or fellowship grants.

The following payments or allowances shall not be considered to be amounts received as a scholarship or a fellowship grant for the purpose of section 117:

^{9/} In the case of a recipient who is not a candidate for a degree, such as taxpayer, Section 117(b)(2) limits the amount of a grant which can be excluded to an amount equal to \$300 times the number of months (up to a maximum of 36 months) for which the recipient received amounts under the grant. In this case taxpayer received amounts under the grant for six months during 1972 and he claimed a deduction of \$1,800. (Op. 12, Appendix B, infra, p. 51.)

^{10/} Because of the importance of Treasury Regulations § 1.117-4(c) (26 C.F.R.), to the resolution of this dispute, its pertinent provisions have been reproduced in full at this point in the brief rather than in Appendix A.

(c) Amounts paid as compensation for services or primarily for the benefit of the grantor. (1) * * * [Any] amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research, if such amount represents either compensation for past, present, or future employment services or represents payment for services which are subject to the direction or supervision of the grantor.

(2) Any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research primarily for the benefit of the grantor.

However, amounts paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research are considered to be amounts received as a scholarship or fellowship grant for the purpose of section 117 if the primary purpose of the studies or research is to further the education and training of the recipient in his individual capacity and the amount provided by the grantor for such purpose does not represent compensation or payment for the services described in subparagraph (1) of this paragraph. Neither the fact that the recipient is required to furnish reports of his progress to the grantor, nor the fact that the results of his studies or research may be of some incidental benefit to the grantor shall, of itself, be considered to destroy the essential character of such amount as a scholarship or fellowship grant.

The Supreme Court in Bingler v. Johnson, 394 U.S. 741, 751 (1969), has upheld the validity of Section 1.117-4(c) of the Regulations. The court stated (Id., p. 751):

* * * the definitions supplied by the Regulation clearly are prima facie proper, comporting as they do with the ordinary understanding of "scholarships" and "fellowships" as relatively

disinterested, "no-strings" educational grants, with no requirement of any substantial quid pro quo from the recipients.

It is readily apparent that the essence of the definitions provided by Regulations section 1.117-4(c) is that to be excludable, an allowance must have been occasioned by disinterested motives, because "bargained-for payments, given only as a quo in return for the quid of services rendered--whether past, present or future--should not be excludable from income as 'scholarship' funds." Bingler v. Johnson, 394 U.S. 741, 757-758 (1969). See also, Logan v. United States, 518 F. 2d 143, 146 (C.A. 6, 1975); Worthington v. Commissioner, 476 F. 2d 589, 590 (C.A. 10, 1973); Leathers v. United States, 471 F. 2d 856, 860-861 (C.A. 8, 1972), cert. denied, 412 U.S. 932 (1973); Ehrhart v. Commissioner, 470 F. 2d 940, 943 (C.A. 1, 1973); Parr v. United States, 469 F. 2d 1156, 1158 (C.A. 5, 1972); Hembree v. United States, 464 F. 2d 1262, 1265 (C.A. 4, 1972); Cf. Stewart v. United States, 363 F. 2d 355, 357 (C.A. 6, 1966).

Whether amounts received by taxpayer by virtue of the NSF grant were excludable from his 1972 income is essentially a question of fact. Ehrhart v. Commissioner, supra, 470 F. 2d, p. 941. Because the ultimate finding of the Tax Court that the amounts were compensation and were not excludable was amply supported--if not virtually compelled--by the record, and because it was not "clearly erroneous", it should not be disturbed on appeal.

Commissioner v. Duberstein, 363 U.S. 278, 289-291 (1960); Wilson v. Commissioner, 500 F. 2d 645, 649 (C.A. 2, 1974); see also, Woodail v. Commissioner, 321 F. 2d 721, 724 (C.A. 10, 1963); Leathers v. United States, supra, 471 F. 2d, p. 858, 864 and fn. 3.

Section 1.117-4(c) of the Regulations specifies two types of grants which do not qualify for exclusion: an amount is not received as a scholarship or fellowship grant, and is therefore not excludable from gross income under Section 117, if either (1) such amount represents compensation for employment services, or (2) such amount is received for services performed primarily for the benefit of the grantor.^{11/} However, the regulation also provides that if the primary purpose of the studies or research is to further the education and training of the recipient, amounts paid to allow a student to pursue such study or research will be considered as amounts received as a grant, provided the amounts do not represent compensation for services.

^{11/} In Bingler v. Johnson, supra, p. 758, fn. 32, the Court noted that it accepted the Government's suggestion that Treasury Regulation §1.117-4(c)(2) merely supplemented §1.117-4(c)(1) in order to tax bargained-for arrangements that do not create an employer-employee relation, e.g., an independent contractor. The Court thus found that the "primarily for the benefit of the grantor" language was an adjunct to the "compensation" provision, although the general idea was the same, i.e., the exclusion does not apply to arrangements whereby the recipient of a grant in turn provides a quid pro quo to the grantor.

These provisions have been applied by the Courts in various formulations. In Reese v. Commissioner, 45 T.C. 407, 411 (1966), aff'd per curiam, 373 F. 2d 742 (C.A. 4, 1967), the Tax Court stated that to qualify for exclusion, the primary purpose of the grant must have been to further the education and training of the recipient rather than primarily to compensate the recipient for services rendered or to be rendered which directly benefit the grantor. The Tax Court continues to apply this "primary purpose" test. See e.g., Carroll v. Commissioner, 60 T.C. 96, 103 (1973); Brubakken v. Commissioner, 67 T.C. 249, 255 (1976). However, the Sixth Circuit in Stewart v. United States, supra, 363 F. 2d, p. 357, stated that it preferred rather to focus on consideration of the facts as indicia of compensation for services as a more meaningful test than that of whether the stipend was primarily for the benefit of the grantor. And, more recently, the Sixth Circuit in Logan v. United States, supra, 518 F. 2d, p. 146, found support in Bingler v. Johnson for this conclusion of the court in Stewart. In Logan the court stated that preference for the indicia of compensation test was consistent with the Supreme Court's statement in Bingler that the "primary benefit" test is "merely an adjunct to the initial 'compensation' provision" of the regulation, 394 U.S., p. 758, fn. 32.^{12/}

In Hembree v. United States, supra, 464 F. 2d, p. 1265, the Fourth Circuit suggested that the Supreme Court in Bingler "bypassed discussion of the 'primary purpose' dialogue" and provided the simple test that if there existed any "substantial quid pro quo,

^{12/} See footnote 11, supra.

i.e., compensation for services" the payments could not qualify for the exclusion of Section 117. Likewise, in Parr v. United States, 469 F. 2d 1156, 1158 (C.A. 5, 1972), the Fifth Circuit, citing Hembree, stated that the Supreme Court adopted a common sense approach to the definition of fellowships, characterizing them as "relatively disinterested", "no-strings" education grants, and thus provided "an additional basis" for its holding in favor of the Government apart from the 'primary purpose' concept."

Under any of the above formulations of the test contained in the Regulations, an analysis of the factors involved in this case leads inevitably to the conclusion that the amounts received by taxpayer by virtue of the NSF grant were not amounts received as a fellowship grant within the meaning of Code Section 117.

B. The amounts paid taxpayer with funds provided by the research grant represented compensation for taxpayer's services

The facts fully demonstrate that amounts paid to taxpayer from the Foundation grant were not disinterested "no-strings" payments but rather represented compensation for a quid pro quo: research into a particularized computer language which would benefit both the University and the National Science Foundation. The overall flavor of the procedures governing both the submission of proposals to and the administration of grants by NSF indicates that the Foundation's prime concern was not the development of taxpayer's skills as a scientist, but was rather the attainment of a specific "project" objective, a factor clearly indicative of non-excludable compensation. See e.g., Gibb v. Commissioner, 32 T.C.M. 784, 787 (1973), aff'd per curiam, 501 F. 2d 1086 (C.A. 6, 1974); Littman v. Commissioner, 42 T.C. 503, 504 (1964).

Taxpayer's "proposed project" was evaluated in terms of and supported in accordance with its merit (Ex. 7-G, p. 13). NSF's Proposal Review Summary (Ex. 3-C) reflects that the staff concern was with taxpayer's research objective which, if attained, would remove a barrier to the development of certain computers. (Op. 4, Appendix B, infra, p. 43.) The University was under an obligation to exercise "[C]onsidered judgment * * * in attaining the research objectives." (Ex. 6-F, p. 1.) Although taxpayer had some leeway to modify the course of his work, reporting to NSF of major deviations from "original research

objectives" was a "must". (Ex. 7-G, p. 22.) Also, neither the broad category nor the "stated objectives" of the research effort could have been modified without written approval of the Foundation. (Ex. 6-F, p. 3.)

The qualifications of taxpayer, clearly relevant to the attainability of stated research objectives (Tr. 21-22), were crucial to the evaluation of the merit of the proposal. (Ex. N, p. 2.) In fact, the availability of his services was a "condition of the grant" (Ex. 7-G, p. 26), and Foundation approval would have been required to change to another principal investigator (Ex. 6-F, p. 3).

Not only do the above factors indicate the concern by NSF with attainment of a specific research objective rather than the development of taxpayer's skills as an end in and of itself, but also they indicate the extent to which NSF maintained "strings" over the use of its money. It should be recalled that Treasury Regulations § 1.117-4(c) specifically provides that amounts paid for "services which are subject to the direction or supervision of the grantor" are not to be considered as amounts received as a fellowship grant. See Kammerer v. Commissioner, 35 T.C.M. 30, 34 (1976); Bachmura v. Commissioner, 32 T.C. 1117, 1126 (1959).

In addition to the procedures by which NSF maintained overall control of the use of its funds, the procedures followed for the payment of monies to taxpayer and the language used by NSF to describe them are indicative of an arrangement for compensation.

The very fact that proposals are submitted by the grantee institution and not by the individual researcher would support a conclusion that a foundation research grant is designed to provide funds to enable educational institutions to carry on research projects for which they lack the funds to support themselves. See Woodfin v. Commissioner, 31 T.C.M. 208, 209 (1972), appeal dismissed (C.A. 10, 1973).

Consistent with this approach NSF 69-23 speaks in terms of "reimbursement of * * * [a principal investigator's] salary" (Ex. 7-G, p. 7). It states that "information on faculty salaries will be used as a basis for determining the salary amounts stipulated in the grant budget." (Id., p. 9) (Emphasis added.) Compare Littman v. Commissioner, 42 T.C. 503, 509 (1964).

Taxpayer received from the University during the period June 27, 1972, to December 31, 1972, amounts which equalled his regular salary, half of which was paid from funds provided by the research grant (Op. 11, Appendix B, infra, p. 50). Taxpayer could not have received any additional grant funds during the period, however, because pamphlet NSF 69-23 provided that funds could not be used to augment the regular salary paid to faculty members. (Ex. 7-G, p. 9.) In this regard NSF considered research to be a normal function of faculty members employed by universities..(Id., p. 10.) Thus,

although taxpayer was on sabbatical leave during the period in question, he continued to receive in effect, salary payments for performing research, one of his normal faculty duties, some amounts of which were reimbursed by NSF to the University to defray some of the costs of the research which would be beneficial to both institutions.^{13/}

The legislative history of Section 117 expressly provides, however, that the exclusion is not to apply to "grants which in effect represent a continuing salary during a period while the recipient is on leave from his regular job." H. Rep. No. 1337, 83d Cong., 2d Sess., pp. 16-17 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4041). But, in effect, the amounts paid to taxpayer from NSF funds during 1972 were precisely that--continuing salary payments.

^{13/} As noted by the Tax Court, prior to taxpayer's departure on his sabbatical, he had already begun his research on the project simultaneous with other faculty duties. Because the University was paying him his full salary, however, NSF money could not have been used as a supplement. (Op. 8, 19, Appendix B, *infra*, pp. 47, 48.) Nevertheless, taxpayer has not attempted to exclude any part of the salary received during 1972 prior to June although he was then engaged in the same research. But apart from the fact that after June taxpayer was performing the research in Europe, no other fact would appear to distinguish an allocable portion of the amounts paid before June and those paid after June. See e.g., *Carroll v. Commissioner*, 60 T.C. 96, 105 (1973). And Rev. Rul. 58-222, 1958-1 Cum. Bull. 54, cited by taxpayer, does not dictate a different conclusion. The Ruling concerned a college teacher who received amounts from his university and from a private foundation while engaged in a research project of his own choosing while on sabbatical leave. The Commissioner ruled that the amount received from the university was taxable, but that the amount received from the private foundation was excludable. Although, the Ruling does not discuss in detail the circumstances surrounding the grant from the private foundation, the Ruling did note that the university exercised no control over the teacher's activities, and he was not obligated to make any reports or render any services to it, and, inferentially at least, it would appear that the private foundation grant did not impose any such requirements upon the teacher. Thus, the facts present there appear to be readily distinguishable from those here involved. In any event, since the inquiry in such cases is essentially factual (*Ehrhart v. Commissioner*, *supra*), the Ruling is of little precedential value here.

In Carroll v. Commissioner, 60 T.C. 96 (1973), the Tax Court considered an NSF research grant in circumstances very similar to those herein. The taxpayer in Carroll was the principal investigator on a research project at the University of Illinois in part supported by an NSF research grant.

The taxpayer there, also a teacher, was expected to devote one-third of his time during the academic year, and all of his time during the summer to the project. The university paid all of his salary during the academic year, and NSF agreed to pay the salary during the summer. The summer payments were made at the regular frequency and in the same amount, and the teacher continued to enjoy all of his faculty benefits. The Tax Court held that the summer payments were not excludable under Section 117. After analysing the salary arrangements, the procedures for selection of meritorious proposals, and the controls maintained by NSF, all of which were governed by procedures substantially similar to those in this case (Op. 18, Appendix B, infra, p. 57), the Court stated (60 T.C., supra, p. 107):

* * * NSF made the funds available to be paid to the petitioner because it wished to have the research performed and to have him [Carroll] perform it, and * * * the university made the payments to the petitioner because it believed that they were due to him for the services that he performed on the research project.

The same result should obtain here.

In addition, as in Carroll, supra, p. 104, the University herein treated the payments, which included NSF funds, as salary payments. The payments during the six month

period in question were equal to taxpayer's normal salary; they were paid at regular two-week intervals; and federal and state taxes were withheld. Also, taxpayer continued to participate in the University's retirement, health and hospitalization plans. (Op. 11, Appendix B, infra, p. 50.) These factors are further indications that the payments to taxpayer were in reality compensation for services. See Bingler v. Johnson, 394 U.S. supra, p. 757. Additionally, the amount of the grant was in no way related to taxpayer's financial need; such a correlation has been termed one of the "hallmarks of fellowship grants." Towns v. Commissioner, 33 T.C.M. 632, 634 (1974); Bailey v. Commissioner, 60 T.C. 447, 454 (1973).

It is apparent, therefore, that the interest of both the Foundation and University was the attainment of a research objective, that NSF maintained overall control over taxpayer's research, that the payments made to taxpayer were identical to regular salary payments in amount and method of payment, and that taxpayer continued to enjoy his regular employee benefits. Accordingly, this Court should affirm the decision of the Tax Court because that Court's decision that taxpayer was not entitled to exclude any part of the payments attributable to the NSF grant from his 1972 income was based upon a finding of ultimate fact, amply supported by the record here and not clearly erroneous, that this grant funds here involved were received as compensation for services.

The case of Bhalla v. Commissioner, 35 T.C. 13 (1960), cited by taxpayer (Br. 14), is of no relevance here. In that case the taxpayer, a candidate for a graduate degree at the University of Tennessee, was given a stipend from his university under a "graduate research assistantship" which was charged against an NSF grant previously received by the university for research relating to nuclear physics. In determining that the amounts received by that taxpayer were excludable as a "scholarship" under Code Section 117(a)(1)(A), the Court found that the primary purpose of the research for which he was paid was to further his training and education, and that the research was not conducted by him primarily for the benefit of the grantor of the stipend. In so finding, the Court noted that he was given credit towards a graduate degree for the research performed by him, that equivalent research was required of all candidates for such a degree,^{14/} and that the university continued with such research after he had terminated his work on this research project. In

^{14/} Code Section 117(b)(1), which applies to degree candidates, provides in part that compensation received for research in the nature of part-time employment is not excludable under Section 117(a), but goes on to state that the performance of research by such candidates shall not be regarded as part-time employment if such research is required of all candidates for a particular degree as a condition of receiving such degree. However, payments for research by degree candidates, which are in reality compensation for services, are not rendered excludable by this statutory provision, even if such research is required of all candidates for the degree. See Reese v. Commissioner, supra, 45 T.C. p. 412.

the present case, however, the taxpayer is not a candidate for a degree, the research grant identified him as the principal investigator on the research project here involved, and, as the Tax Court found (Op. 17, Appendix B, infra, p. 56), the research here was conducted primarily for the benefit of the grantor, and its primary purpose was not to further taxpayer's education and training. Thus, Bhalla presented a situation distinguishable in these crucial respects from the facts present here, and that case, accordingly, offers no support for the exclusion here sought by taxpayer. ^{15/}

^{15/} Other cases cited by the taxpayer involving amounts received for the purpose of enhancing the skills of persons who were in the process of being trained, likewise are readily distinguishable. In Evans v. Commissioner, 34 T.C. 720 (1960), acq., 1965-1 Cum. Bull. 4, the fact that a stipend received by the taxpayer therein, a trainee in a psychiatric nursing program, was directly related to her financial needs was crucial to the determination by the Tax Court that the primary purpose of the payments was to enable the taxpayer to complete her training. (Id., p. 726.) In addition, the taxpayer rendered no specific services for the grantor and was not treated as an employee. In Wells v. Commissioner, 40 T.C. 40 (1963), the taxpayer participated in the first year of a four-year training program at a VA hospital for students in clinical psychology. Noting that taxpayer was inexperienced in clinical work, worked only part-time, was strictly supervised and performed services of little value, the court determined that the hospital's payments were primarily to develop the taxpayer's skills.

C. The primary purpose of the research was not to further the education and training of taxpayer in his individual capacity

Treasury Regulation Section 1.117-4(c) also provides that amounts paid to an individual are considered to be amounts received as a scholarship or fellowship grant excludable under the terms of Section 117 if the "primary purpose" of the research is to further the education and training of the recipient,^{16/} provided, however, that they do not represent compensation as set out in Section 1.117-4(c)(1), i.e., compensation for "employment services" or "services * * * subject to the direction or supervision of the grantor." However, on the facts present here, it is clear that the furtherance of taxpayer's education and training was not the primary purpose of the NSF grant, and thus this provision of the Regulations has no application to the present case.

To qualify a portion of the NSF grant for exclusion from his income under this provision of the Regulations, it is not sufficient that the taxpayer may have derived incidental training and increased skills as a result of his work financed in part by

^{16/} In this connection, Regulations Section 1.117-4(c), supra, p. 18, goes on to state that neither the fact that the grant recipient is required to furnish progress reports to the grantor, nor the fact that the research may be of some incidental benefit to the grantor is, of itself, sufficient cause to deny the exclusion to non-compensatory grants whose primary purpose is to further the education and training of the recipient within the meaning of the above-cited proviso of Section 1.117-4(c). However, since the grant here involved was not for such a primary purpose, and was compensatory, taxpayer's contentions here gain no support from this language of the Regulations.

the NSF grant, even if the taxpayer may have considered such benefits to have been the primary purpose of the grant. See, e.g., Carroll v. Commissioner, supra, 60 T.C. p. 108; Littman v. Commissioner, supra, 42 T.C., p. 510; Gibb v. Commissioner, supra, p. 787. In Woodfin v. Commissioner, supra, where amounts paid to the taxpayer for her research on a project funded by a grant awarded by NSF to the University of Michigan were held not excludable, the Tax Court stated (31 T.C.M., p. 223):

Admittedly, petitioner may have derived substantial educational training and experience in her chosen profession from her work on the project involved. But the existence of such benefits is hardly inconsistent with our finding that the payments to her were made primarily for the benefit of the University. * * * Virtually all well organized projects of a scientific nature provide valuable training and improve the academic background of the participants. Nothing in section 117 requires that the stipend, paid as compensation for services rendered, be treated as a nontaxable fellowship grant merely because the recipient is increasing his knowledge and acumen in his trade, business, or profession.

Similarly, in Ehrhart v. Commissioner, supra, where living allowances paid by insurance companies to their actuarial employees attending graduate school in actuarial science were held not excludable, the Court of Appeals for the First Circuit stated (470 F. 2d, p. 944):

Nor does it detract from the Tax Court's conclusion [that the allowances were primarily for the benefit of the insurance companies] that, from the * * * [taxpayer's] standpoint, the program offered substantial benefits to him. We do not read the Regulation [excluding from the definition of "scholarship" or "fellowship grant" amounts paid or allowed to an individual to enable him to pursue studies or research primarily for the benefit of the grantor (§ 117-4

(c)(2))] as a "zero sum game", where benefit to the * * * [grantor] means loss to the * * * [grantee]. * * * The question is whether the * * * [grantor's] objective was primarily its own benefit--not whether the * * * [grantor's] actual gain exceeded or outweighed the * * * [grantee's].

The more relevant inquiry is whether the raison d'etre of the payments by NSF was to enable taxpayer to pursue the research primarily for his own benefit. Thus, in Peiss v. Commissioner, 40 T.C. 78 (1963), appeal dismissed (C.A. 7, 1964) (a case cited by taxpayer) where the taxpayer, an associate professor, was the recipient of a research grant made by the Markle Foundation, the court found that the primary purpose of the grant was to enable the taxpayer to further his research activities. The court noted that the foundation had been created "to promote the advancement and diffusion of knowledge * * * and the general good of mankind." (40 T.C., p. 78.) The foundation's pamphlet stated that the grants were given to promising young teachers as a financial inducement to remain in the academic field.^{17/} T.C., p. 79.)

^{17/} As noted in Carroll, supra, p. 107, NSF did have a program of making fellowship grants to individuals, where its concern was developing their competency, but the standards for such grants were different than the grant here involved because the purpose of such fellowship grants is quite different than the objective in supporting proposed research.

The grant involved in Peiss, however, had several important features which distinguish it from the grant under consideration here. The taxpayer in Peiss was not required to work toward any particular objective--indeed, the court pointed out that he would have received the grant if he had performed no research. (40 T.C., p. 82.) Further, if the taxpayer had transferred to another school, the grant would have followed him there. (40 T.C., p. 79.) The only apparent condition upon the continuation of grant payments was that the recipient remain in the academic world as a full-time faculty member. Thus, it is clear that the arrangement in Peiss comported far more closely to what the Supreme Court stated to be the ordinary understanding of fellowships as relatively "disinterested", "no-strings" grants (Bingler v. Johnson, supra, 394 U.S., p. 751), than does the grant here involved.

In another case relied on by taxpayer, Stone v. Commissioner, 23 T.C. 254 (1954), appeal dismissed (C.A. 4, 1955) (which was decided prior to the enactment of Section 117 when the question of excludability depended on whether the grant amounted to a gift), the court held that a fellowship given taxpayer Stone by the John Simon Guggenheim Foundation was excludable. The court found that such grants were made primarily to assist scholars to carry on their own research (Id., p. 256). The court noted the research was in a field of taxpayer's own selection, the foundation assumed no authority to direct or supervise the work or even to see if it was satisfactorily done, and it required no interim or final reports. (Id., pp. 262-263.)

In contrast to both Peiss and Stone, NSF approved the grant here involved primarily because of its interest in achieving the objective of the study. Moreover, in addition to the required program reports, and the retained authority to determine whether any patent applications would be filed, NSF retained authority to approve or reject any suggested major deviation from the approved course toward the original objective. In short, the NSF grant was not given with the "disinterested", "no-strings" spirit described by the Supreme Court. Rather it was given with a specific objective in mind and it was subject to several conditions enabling NSF to control the course of the work.

The case of Vaccaro v. Commissioner, 58 T.C. 721 (1972), acq., 1973-1 Cum. Bull. 2, relied on by taxpayer, is readily distinguishable. In Vaccaro, the taxpayer was a research associate in a project at a center for the advanced study of educational administration at the University of Oregon funded in part by the Office of Education of the Department of Health, Education and Welfare (HEW). The taxpayer there, who had held a teaching position at another university, took a year's sabbatical at Oregon during which he took post-doctoral courses and pursued independent research projects, some of the results of which he published. However, he was under no obligation to perform work on any specific project and in fact he did not. (Id., pp. 728-729.) Moreover, from the original application which had been filed with HEW, it was evident that the position which the taxpayer filled had been created to enable

the center at the university to train competent researchers and thereby upgrade the quality of educational administrators generally. (Id., pp. 723-724.) These factors, which are in marked contrast to the situation presented here, were the basis upon which the court in Vacarro determined that the primary purpose of the grant to the taxpayer there was to enable him to improve his skills and was not to compensate him for any particular services. (Id., p. 728.)^{18/}

As has been demonstrated, the authorities cited by taxpayer involving situations where it was determined that the primary purpose of the grant was to enable the recipient to improve his skills are readily distinguishable from the terms of the NSF grant in the instant case. Here, the NSF grant was given only for a quid pro quo--research on a particular project which had been specifically approved by NSF. Accordingly, no part of the payments received under this NSF grant were excludable pursuant to Code Section 117.

^{18/} Rev. Rul. 60-130, 1960-1 Cum. Bull. 46, cited by taxpayer, may be distinguished on the same basis. The ruling involved grants from the American Cancer Society the primary purpose of which was to develop highly trained cancer researchers, and did not involve compensation for work on any particular project.

CONCLUSION

For all the above-stated reasons, the decision of the Tax Court should be affirmed.

Respectfully submitted,

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JULY, 1977.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on the appellants, appearing pro se, by mailing four copies thereof on this 30th day of June, 1977, in an envelope, with postage prepaid, properly addressed to them as follows:

Nicholas V. Findler
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APPENDIX A

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 117. SCHOLARSHIPS AND FELLOWSHIP GRANTS.

(a) General Rule.--In the case of an individual, gross income does not include--

(1) any amount received--

(A) as a scholarship at an educational institution (as defined in section 151(e)(4)), or

(B) as a fellowship grant, including the value of contributed services and accommodations; and

(2) any amount received to cover expenses for--

(A) travel,

(B) research,

(C) clerical help, or

(D) equipment,

which are incident to such a scholarship or to a fellowship grant, but only to the extent that the amount is so expended by the recipient.

(b) Limitations.--

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(2) Individuals who are not candidates for degrees.--
In the case of an individual who is not a candidate for a degree at an educational institution (as defined in section 151(e)(4)), subsection (a) shall apply only if the condition in subparagraph (A) is satisfied and then only within the limitations provided in subparagraph (B).

(A) [as amended by Sec. 110(a), Mutual Education and Cultural Exchange Act of 1961, P.L. 87-256, 75 Stat. 527] Conditions for exclusion.--The grantor of the scholarship or fellowship grant is--

(i) an organization described in section 501(c)(3) which is exempt from tax under section 501(a),

(ii) a foreign government,

(iii) an international organization, or a binational or multinational educational and cultural foundation or commission created or continued pursuant to the Mutual Educational and Cultural Exchange Act of 1961, or

(iv) the United States, or an instrumentality or agency thereof, or a State, a territory, or a possession of the United States, or any political subdivision thereof, or the District of Columbia.

(B) Extent of exclusion.--The amount of the scholarship or fellowship grant excluded under subsection (a)(1) in any taxable year shall be limited to an amount equal to \$300 times the number of months for which the recipient received amounts under the scholarship or fellowship grant during such taxable year, except that no exclusion shall be allowed under subsection (a) after the recipient has been entitled to exclude under this section for a period of 36 months (whether or not consecutive) amounts received as a scholarship or fellowship grant while not a candidate for a degree at an educational institution (as defined in section 151(e)(4)).

APPENDIX B

T. C. Memo. 1976-352

UNITED STATES TAX COURT

NICHOLAS VICTOR FINDLER and CATHERINE FINDLER, Petitioners
v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 6363-75.

Filed November 22, 1976.

Nicholas Victor Findler, pro se.

David R. Smith, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SCOTT, Judge: Respondent determined a deficiency in petitioners' income tax for the calendar year 1972 in the amount of \$378.88.

[- 2 -]

The issue for decision is whether amounts received by petitioner Nicholas Victor Findler from the Research Foundation of the State University of New York from funds provided under a National Science Foundation grant constituted a scholarship or fellowship grant within the meaning of section 117(a), I.R.C. 1954.¹

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

Petitioners, husband and wife, who were residents of Snyder, New York, at the time of the filing of their petition in this case filed a joint Federal income tax return for the calendar year 1972 with the Internal Revenue Service Center at Andover, Massachusetts.

During the year 1972 and for some years prior thereto Nicholas Victor Findler (petitioner) was a professor in the Department of Computer Science

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All statutory references are to the Internal Revenue Code of 1954, unless otherwise noted.

[- 3 -]

at the State University of New York at Buffalo (the university) and was also the Director of Graduate Studies at that institution. Petitioner was not a candidate for any scholastic degree during the year 1972.

On April 5, 1969, the Research Foundation of the State University of New York, Albany, New York (the grantee institution) submitted to the National Science Foundation (NSF) a proposal for a research project to be conducted under the auspices of petitioner as principal investigator, requesting a grant to fund the project. The research proposal submitted by the grantee institution stated that it was submitted in behalf of the university, that the principal investigator was petitioner, and that the title of the proposed research was "Extensions to and Applications of an Associative Memory, Parallel Processing Language, AMPPL." The proposed starting date was stated to be July 1, 1969, the proposed duration 2 years, and the amount requested \$67,404. The proposal stated that the research would be conducted at the university and contained an outline of the proposed

project. It described the facilities available at the university for use in the project and a detailed resume with respect to petitioner. The resume showed that petitioner had both a B.E. and a Ph.D. degree, that he had held a number of positions as professor at various universities, as well as research positions, that he had won a number of prizes and fellowships, had published a number of articles, many of them dealing with computer studies, and had published two books. The budget contained in the research proposal indicated that of the \$67,404 requested the university's contribution would be \$6,740, part of which was a percentage of the salary of the principal investigator, petitioner.

The staff summary contained in the "Proposal Review Summary and Program Recommendations" prepared by a program director of NSF with respect to the research proposal submitted by the grantee institution stated as follows:

This is good work in an important area. Several proposals for construction of associative memory and parallel processing machines have been made and one or two are being constructed but a major barrier has been the design of appropriate programming languages. This constitutes a conceptual as well as practical barrier since it is difficult for people to visualize the application of parallel processing and associative memory to a wide range of problems. Prof. Findler is attacking precisely this problem and should be supported.

Under date of August 14, 1969, the grantee institution received a letter from NSF stating that a grant of \$54,200 was made with respect to the proposal and that the foundation required that the grant be administered in accordance with "Grants for Scientific Research," June 1963 (as amended December 1963 and supplemented by Important Notice of January 24, 1966), and the approved budget summary.

On December 15, 1970, the grantee institution submitted to NSF a supplementary research proposal requesting an extension of the original research grant. This supplemental proposal was likewise submitted on behalf of the university with petitioner as principal investigator. The title of the proposed research was stated to be "Further Studies Using the Associative Memory, Parallel Processing Language, AMPPL-II." The starting date proposed was September 1, 1971, the proposed duration 3 years, and the amount requested \$357,713. This supplemental research proposal set forth a summary of the work which had been done over the last 18 months using the support

of NSF and activities which were currently being undertaken. This supplemental proposal also contained a resume of petitioner, the principal investigator, and a proposed budget. The proposed budget showed that the university contribution in connection with the projects described would be made in accordance with NSF Notice No. 31, "Cost Sharing on Research Projects," and that the university contribution included a portion of the salary of the principal investigator.

Under date of January 19, 1972, the grantee institution received a letter from NSF stating that an additional \$150,500 was granted for renewed support of the project entitled "Associative Memory, Parallel Processing Language, AMPPL-II" as outlined in the supplemental proposal. The letter stated that the funds were intended to support the project for an additional 24 months. This letter further stated:

The Foundation shall have the right to require the grantee, at no cost to the grantee, to duplicate, or permit others to duplicate, and deliver to the Foundation or to any person designated by the Foundation, any computer programs, instructions or other software produced under this grant, which may, in the opinion of an authorized Foundation official,

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be useful for research, education or other legitimate purposes by others; provided that no such requirement shall be imposed without affording the grantee a reasonable opportunity to correct errors or to document errors and ambiguities therein.

Except as modified by this amendment, including Enclosure R-12, the grant conditions remain unchanged.

Enclosure R-12 stated that the grant should be administered in accordance with Part II of NSF 69-23, "Grants for Scientific Research," as modified by NSF Important Notice No. 40 and by the enclosure. Enclosure R-12 provided, with respect to patents and inventions, that whenever any invention which is or may be patentable is conceived or first actually reduced to practice in the course of the grant, the grantee shall furnish the foundation with complete information thereon and the foundation shall have the right to determine whether or not and where a patent application shall be filed and to determine the disposition of the invention and title to and rights under any application or patent that may result.

NSF 69-23, referred to in the enclosure with the letter approving the grant for the research to be done by petitioner, stated that NSF was authorized to initiate and support scientific research and programs to strengthen scientific research potential.

The further statement was made that the guide contained instructions for submitting research proposals and referred to other projects supported by NSF. NSF 69-23 stated that proposals were normally initiated by the scientist interested in doing the work and submitted on his behalf by his organization, and that most proposals received by NSF are submitted by universities and colleges on behalf of their staff members. It further stated that the principal investigator is responsible for direct supervision of the project and will participate in the research whether or not his institution is to receive any reimbursement of his salary from grant funds and that, as a general policy, NSF recognizes that salaries of tenured and non-tenured faculty members associated with the research constitute appropriate direct costs in proportion to the time devoted to the research. It is further stated that the summer salary for a faculty member generally would not be reimbursed for more than two-ninths of his academic salary. NSF 69-23 contained the following statement:

The Foundation regards research as one of the normal functions of faculty members at institutions of higher education. Compensation for time spent on research within the term of appointment is deemed to be included within the regular institutional salary of the faculty member. Therefore, grant funds may not be used to augment the total salary or rate of

salary of faculty members during the period of time covered by the term of faculty appointment or to reimburse faculty members for consulting or other time in addition to a regular full-time institutional salary covering the same general period of employment. In any Foundation supported scientific research grant, the institution is deemed to be the grantee and responsibility for work performed by a faculty member under such a grant rests with the institution.

NSF 69-23 further stated that scientists serving as members of the NSF staff review and evaluate all proposals submitted to NSF and that in general proposals would be supported in order of merit to the extent permitted by available funds. NSF 69-23 further provided:

Primary responsibility for general supervision of all grant activities rests with the grantee institution; the principal investigator is responsible for the scientific work. Grantees and principal investigators are encouraged to seek advice and opinion from the Foundation on problems that may arise. * * *

* * *

The grant letter includes a budget summary which lists the items for which funds are provided. The grant is made to the investigator's institution and it is the institution which bears the primary responsibility for fiscal accountability. * * *

* * *

The Foundation believes that the principal investigator, operating within the established policies of the grantee institution, should feel free to pursue interesting and important leads which may arise during the conduct of the research. * * * However, on occasions when new and promising leads or fruitless lines of inquiry do arise, leading to possible major deviations from original research objectives, the Foundation must be informed.

NSF 69-23 also set forth the reports required by the NSF which included short annual technical reports and interim fiscal reports. It stated that NSF does not transfer grants from one institution to another and in the event a principal investigator changes his official affiliation a new proposal through the new institution must be initiated.

NSF 69-23 specifically provided for special approval for purchase of permanent items costing in excess of \$1,000, foreign trips, and changes involving senior personnel in the project. Also, the right to use published material resulting from the performance of the research was reserved to the United States Government.

During the first half of 1972 petitioner performed his normal teaching and administrative duties at the university while working on the project for which a grant was received from NSF. During this period none of petitioner's salary was reimbursed to the university through the NSF grant. From June 27, 1972 throughout the end of that year petitioner was on sabbatical leave from the university. He spent this entire period in various

European cities where he was engaged in work on the research project approved by NSF of which he was principal investigator.

For the period June 27, 1972 to December 31, 1972, petitioner received \$11,268.98 of which \$5,628.98 was paid to him by the university and \$5,640 was paid to him by the grantee institution with funds provided by NSF under the research grant. The \$11,268.98 represented petitioner's then current salary from the university for a 6-month period, with one-half being paid by the university and the other half under the research grant. Petitioner continued to participate in the retirement program of the university during the last 6 months of 1972 and also in the university-sponsored hospitalization and group health program. Federal and State income taxes and Social Security taxes were withheld from all payments which petitioner received during the last 6 months of 1972, including those received from the grantee institution from funds provided under the NSF grant. Petitioner received both his salary payments from the university and his payments from the grantee institution every 2 weeks during the period June 27, 1972 through December 31, 1972.

During 1972 petitioner was assisted in his research carried on in accordance with the grant proposal by four graduate students. Provision for participation by these graduate students had been made in the NSF budget awarding the grant. During the period June 27, 1972 through the end of that year petitioner performed none of his regular services for the university.

Petitioners on their Federal income tax return for the year 1972 deducted \$1,800 from their total reported income with the explanation that one-half of the amount received by petitioner during the last 6 months of 1972 had been a "post-doctoral fellowship."

Respondent in his notice of deficiency increased petitioners' income by \$1,800 with the explanation that the amount of \$1,800 excluded by petitioners from income as a fellowship grant "is not allowable since the stipends received with respect to the National Science Foundation Grant represent compensation for services rendered and do not qualify under Section 117 of the Internal Revenue Code of 1954."

OPINION

Section 117 provides that gross income of an individual does not include amounts received as a fellowship grant. In the case of individuals who are not candidates for a degree the amount of the fellowship grant which may be excluded from income is limited to \$300 times the number of months for which the recipient receives amounts under the grant.

Section 1.117-4, Income Tax Regs., lists certain items which are not considered as fellowship grants. One of these items is amounts paid as compensation for services or primarily for the benefit of the grantor. Under this regulation, amounts representing compensation for past, present or future employment services or for services which are subject to the direction or supervision of the grantor, or amounts paid to an individual to enable him to pursue studies or research primarily for the benefit of the grantor are not considered excludable fellowship grants. The validity of these provisions of the regulations was upheld in Bingler v. Johnson, 394 U.S. 741, 751(1969).

Petitioner takes the position that the payments he received through the grant made by NSF for the research proposal on which he was working were not in the nature of compensation within the meaning of respondent's regulations since he made the proposal of the project, and his activities in conducting the research under the proposal were in no way directly supervised. Petitioner stresses the fact that during the last 6 months of 1972 he was carrying on his research in Europe and not on the campus of the university.

Respondent takes the position that research is an expected part of a professor's work and that NSF sponsored the research on the project on which petitioner was working because of its interest in having that research work done. Respondent argues that the facts here show that petitioner was rendering services in doing research during the last 6 months of 1972 for which services he was compensated from the NSF grant funds. Respondent contends that since the payments petitioner received from the NSF grant were compensation for services rendered, petitioner is not entitled to the exclusion from income which he claimed as a fellowship grant.

Both parties cite a number of cases and revenue rulings involving claimed deductions for scholarship or fellowship grants. Some of the cases cited by each of the parties deal with scholarships or fellowships granted to candidates for a degree and others deal with persons serving as residents or interns in hospitals. One of the rulings cited by petitioner deals with a professor doing research on sabbatical leave, but under factual circumstances totally distinguishable from those here present. Suffice it to say that except for the case of Robert W. Carroll, 60 T.C. 96 (1973), none of the cases cited by either party deal with facts comparable to those here present. Since, in our view, there is no substantive distinction between the facts in the Carroll case and those in the instant case, no useful purpose would be served in discussing and distinguishing the numerous other cases cited by the parties.

The facts in the Carroll case are exactly the same as those in the instant case except that the payments to the taxpayer in that case from funds from an NSF grant were for summer work in the taxpayer's home rather than as here for work in Europe while

petitioner was on sabbatical leave. The NSF grant from which the taxpayer in the Carroll case received payments was for a project approved under the same NSF program as the grant in the instant case. The taxpayer in the Carroll case was the principal investigator on the project as was petitioner in the instant case. In the Carroll case the taxpayer's project was sponsored by the university by which he was employed as a professor as was petitioner's project in this case.

The only distinction that petitioner attempts to make between the case of Robert W. Carroll, supra, and the instant case is that the taxpayer in the Carroll case was doing his research in the location of the university where he was employed as a professor rather than in Europe. Petitioner does not deny that the requirements of NSF with respect to the research proposal in the Carroll case and the instant case were the same or that the criteria governing approval and the standards to be met were the same with respect to the project in the Carroll case and the instant case. It is petitioner's argument that since his work was being carried on in Europe instead of at the facilities

of the university, the Carroll case should be held not to be applicable with respect to this case.

In the Carroll case, supra at 101, we found that "[i]n each of the years 1965 and 1967, the petitioner actually performed research in his home, in accordance with the proposals submitted to NSF. As a principal investigator on the project, the petitioner was in charge of his own work, and such work was not under the direction or supervision of anyone else."

In our view, whether an unsupervised researcher is working in his own home in the city where the university by which he is employed is located or is working in Europe is not an important factor. The important factors are the nature of the work done by the principal investigator, the circumstances under which the principal investigator undertakes the research work, the requirement of the grantor for approval of the project, and the reasons for the approval of the project by the grantor. Therefore, in our view there is no distinction in the Carroll case and the instant case. On the basis of the Carroll case, we hold that the payments received by petitioner in 1972 from funds provided by NSF were compensation.

As we pointed out in the Carroll case, the NSF pamphlet with respect to research grants indicated that NSF funds could not be used to augment the salary of a faculty member for work performed during the academic year, but could include payments of salary for research performed during the summer period or while on sabbatical leave. Substantially the same provisions which we set forth as being in the NSF pamphlet in the Carroll case were in the pamphlet in effect at the time the research project in the instant case was approved. In fact, petitioner testified that had he been paid his full salary by the university while on a 6 months sabbatical in 1972, no funds of NSF under the grant could have been paid to him. The only NSF funds which he could receive was an amount to bring his pay for the 6 months period while he was on sabbatical to the level of the salary which would have been paid him by the university had he not been on sabbatical. Petitioner here recognizes, as did the taxpayer in the Carroll case, that as a professor he is expected to do research.

In the Carroll case we called attention to the legislative history of section 117 which made it clear that it was not the intent of Congress that grants which were in effect continuing salary payments to the recipient while on leave from his regular job be considered as fellowship grants. Here, part of petitioner's regular job and part of the activity he undertook during the school year while he was performing his other functions at the university was research on the project for which NSF had made a grant. When he went on sabbatical leave and pursued this research full-time instead of part-time, the nature of his research work was unchanged. He was still pursuing the research as a part of his work as a professor and in accordance with the NSF grant.

Since petitioner in the instant case had so many years of work in the area with which his research dealt, it is not even shown by this record that his education was enhanced by the research he did in 1972. In any event, in this case as in the Carroll case the facts as a whole show that the funds were made available for petitioner's project because NSF wished to have the research performed

and to have it performed by him, and that the payments made to petitioner from the NSF funds were for the services he performed on the research project. Here, as in the Carroll case, an essential element of having the research proposal approved was the qualifications of petitioner to perform the important research he had outlined. The grant was made to support the proposed research which NSF determined should be performed.

In the Carroll case we stated (at 106):

NSF seeks to further research which it finds to be in the public interest. Because it found that the research proposed by the petitioner met that standard, NSF made funds available to support such research. The university is interested in encouraging the members of its faculty to perform research, and for that reason, it undertook to administer the grant made by NSF and to make its facilities available for the performance of such research.

This statement is equally applicable in the instant case. Here, as in the Carroll case, petitioner continued to be covered by the employee benefit programs of the university during the 6-month period he was working exclusively on research under the proposal approved by NSF.

For the reasons we have stated, as well as all the reasons stated in the case of Robert W.

Carroll, we conclude that petitioner is not entitled to the exclusion from income claimed in 1972 for amounts received as a fellowship grant.

Decision will be entered
for the respondent.